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CHARLES EDMUND CUDDELEY

IN THE
Supreme Court of the United States

OCTOBER TERM 1941

No. 757

IN THE MATTER
OF
THE PRUDENCE COMPANY, INC.,
Debtor.

IN THE MATTER
OF
AMALGAMATED PROPERTIES, INC.,
Debtor.

IN THE MATTER
OF
A PLAN OF REORGANIZATION OF AMALGAMATED PROPERTIES, INC., Debtor, in respect of the ZO-GALE FIRST MORTGAGE PARTICIPATION CERTIFICATES.

PRUDENCE REALIZATION CORPORATION,
Petitioner,

A. JOSEPH GEIST, Trustee,
Respondent.

In Consolidated
Proceedings for
Reorganization
under Section 77B
of the
Bankruptcy Act.

Nos. 27496 and
27028.

**REPLY BRIEF OF PETITIONER IN SUPPORT OF
PETITION FOR WRIT OF CERTIORARI**

IRVING L. SCHANZER,
Counsel for Prudence Realization
Corporation, Petitioner.

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In his answering brief, respondent urges that the petition be denied because the certificates held by petitioner constitute a subordinate interest in the mortgage, (a) by the terms of the certificates themselves, and (b) by virtue of the default committed by petitioner's predecessor, the guarantor (Respondent's Brief, p. 6).

In reply petitioner respectfully submits that respondent's characterization of petitioner's participation as "a subordinate interest in the mortgage" is erroneous under decisions of the same court as that upon whose decisions respondent and the majority of the Court below relied in reaching the conclusion in this case.

In *In The Matter of the New York Title and Mortgage Company* (381-383 Park Avenue), 163 Misc. 318, aff'd without opinion 254 N. Y. App. Div. 722, the New York court held that the certificates held by Superintendent of Insurance as statutory liquidator of the guarantor were subordinate in time of payment to certificates held by others, but his interest was neither a junior interest in the mortgage nor a second mortgage. The court therefore refused to permit the trustee of the reorganized certificate issue to wipe out the Superintendent's interest in the mortgage in a foreclosure proceeding. That decision was predicated upon a determination that under the New York decisions, even though the guarantor's interest in the *proceeds* of the certificated mortgage was subordinate in time of payment to that of other holders, the interest of the guarantor in the mortgage itself was coordinate in lien with the interest of such holders. The "lien" cases cited by respondent under Point II of his brief therefore are inapplicable.

Although respondent refers to the certificate itself to show a clear agreement for subordination, an examination of the certificate shows no language indicating a priority right in favor of other holders as against Prudence. Moreover, the certification, printed on the certificate, made by the depository, specifically states " . . . that the interest of the holder of this certificate in said bond and mortgage is not subordinate to any other shares thereof and is not subject to any prior interest therein" (R. 15). Respondent further urges that the failure of Prudence to reserve to itself the right to hold certificates automatically requires subordination. However, there was no necessity for an express reservation of the right in Prudence to hold cer-

tificates. It did not issue the securities nor was it a trustee or depositary. Prudence was in fact the first holder of the certificates, having paid the full face value for the certificates, and sold them, not as an issuer but as such holder for value, to persons desiring to acquire a portion of its interest in the mortgage. No greater reason exists for requiring a reservation in favor of Prudence's retention or reacquisition of certificates than for a similar requirement in the case of subsequent purchasers who sold part or all of their holdings and later reacquired a portion of the sold certificates.

In relying upon the fact of the default by Prudence on its guaranty to substantiate the asserted right to priority in favor of other certificate holders, respondent ignores the further and controlling fact of the bankruptcy of the guarantor. The theory upon which respondent proceeded in the district court, and upon which he entered his order upon that court's determination, was not that the mortgage debt must be satisfied, but that no payments are to be made to petitioner until the *guaranty obligation* of the bankrupt guarantor to other Zo-Gale certificate holders has been fully paid (R. 50). Enforcement of the guaranty obligation in the forum in which the certificated mortgage was reorganized rather than in that of the guarantor's bankruptcy, and without regard for the rights of other creditors of the bankrupt guarantor, results in unauthorized preferences and is inconsistent with the policy and purpose of the Bankruptcy Act.

The "special equities" which respondent urges in favor of the Zo-Gale certificate holders as against other Prudence creditors are based solely upon the assertion of such equities by the New York Court of Appeals in cases arising in that court, but not involving a guarantor whose estate was being reorganized under the Bankruptcy Act. The debtor-creditor relationship existing between the Zo-Gale certificate holders and Prudence, upon which respondent relies to establish such "special equities" in favor of the Zo-Gale

certificate holders, is no different than the legal position of the other guaranty creditors of Prudence. The equities in fact lie with such other creditors as opposed to the special Zo-Gale group, as has been aptly illustrated in 51 Yale Law Journal 315, where in discussing the instant case the writer states at page 321:

"Several elements of the immediate situation favor according equality of participation to the certificates held by the guaranteeing company. It is only the circumstance of that company's choice to invest in one of its own issues, rather than to distribute the entire issue to the public, which leads to its subordination in the principal case. Furthermore, the public holders of other issues of mortgage participation certificates and miscellaneous other creditors, in making their investment, relied upon the assets of the guaranteeing company, a part of which consisted of retained or re-acquired shares. From the point of view of these other general creditors of the guarantor, the participating certificates held by the company would be considered substituted value for general assets expended in their acquisition, a consideration rejected by the decision in the instant case."

All published comments concerning the Circuit Court of Appeals decision in the instant case reject the majority's conclusion that the state court decisions are controlling upon the federal court in this case under *Erie R. Co. v. Tompkins*, 304 U. S. 64, 58 S. Ct. 817, 82 L. Ed. 1188. See 51 Yale Law Journal 315, 319; 55 Harvard L. Rev. 283, 284. Moreover, such comments concur in Judge Frank's conclusion that the New York decisions establish a rule of insolvency distribution. 51 Yale Law Journal 315, 320; 55 Harvard L. Rev. 283, 284. The majority conceded that such a rule would not be binding upon the federal courts.

The erroneous extension of the rule of *Erie R. Co. v. Tompkins*, *supra*, to the instant case by the Circuit Court of Appeals has created a precedent which jeopardizes the uniformity of administration of the Bankruptcy Act, and permits the several states by judicial determination or

statutory enactment to control the enforcement of the Bankruptcy Act. That extension is unauthorized by the decision of this Court in *Eni R. Co. v. Tompkins, supra*, and should be reviewed.

Wherefore, your petitioner prays that its petition for a writ of certiorari should be granted to review the order and decision of the Circuit Court of Appeals for the Second Circuit in this case.

Respectfully submitted,

IRVING L. SCHANZER,
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Corporation, Petitioner.

December, 1941.